No. 3920

United States Circuit Court of Appeals

For the Ninth Circuit

FIDELITY AND DEPOSIT COMPANY OF MARYLAND, a Corporation, and MARYLAND CASUALTY COMPANY, a Corporation. *Appellants,*

vs.

KELSO STATE BANK, an Insolvent Banking Corporation, and JOHN P. DUKE, as Supervisor of Banking of the State of Washington, in Charge of and Liquidating the Assets of the Kelso State Bank, *Appellees.*

Upon Appeal from the United States District Court
for the District of Oregon
HON. R. S. BEAN, District Judge

Brief of Appellees

MILLER, WILKINSON & MILLER
205-208 U. S. National Bank Building
Vancouver, Washington
Solicitors for Appellees.

A. L. MILLER,
Vancouver, Washington,
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DUNCAN PRINTING CO., VANCOUVER, WASH

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ARGUMENT

The amended complaint in this matter in effect charges that at the time the deposits in question were made the Kelso State Bank was hopelessly insolvent and that the officers of the bank knew the bank to be hopelessly insolvent and by reason of the insolv-

ency the title to the county funds did not pass to the bank but remained in the county treasurer.

It is further charged that with the deposits made on the 14th day of March, 1921, the bank purchased the warrants in question, amounting to $33,491.59, and that the said warrants thereby became and were the property of Cowlitz County and the county treasurer became entitled to their posession; that after purchasing the warrants with county funds the warrants were left with the United States National Bank of Portland to be held by the bank as trustee for the use and benefit of the county treasurer of Cowlitz County, *to secure the deposits of county funds of said Cowlitz County which said county treasurer had made in said Kelso State Bank* and that the United States National Bank accepted the warrants as such trustee and agreed to hold the same for the use and benefit of the county treasurer as security for county funds of Cowlitz County *theretofore* deposited by said county treasurer in said Kelso State Bank.

All of these allegations are denied.

Before appellants can recover they must establish by a preponderance of the proof:

I.

That at the time the deposits were made the bank was hopelessly insolvent.

II.

That the bank officers at the time the deposits were received knew, or by reason of its hopelessly insolvent condition were legally chargeable with knowledge, of its insolvency.

III.

That the funds deposited with the county treasurer became trust funds and that with these funds the warrants in question were purchased.

IV.

That the deposits were made at a time when the bank was hopelessly insolvent, and known to be so by the officers, that it constituted a fraud and established a trust *ex maleficio,* and that the funds deposited under such conditions can be traced to the warrants in question.

V.

That after the warrants were so purchased they were left with the United States National Bank of Portland to be held in trust for the use and benefit of the county treasurer of Cowlitz County as security for the county funds theretofore deposited by the treasurer in the Kelso State Bank.

Considering these matters in the order stated we would call the court's attention to the necessity of appellants establishing by a preponderance of the evi-

dence that at the time the deposits were made the Kelso State Bank was hopelessly insolvent.

To make a general deposit a trust fund by reason of the insolvent condition of the bank at the time the deposit was made it is not sufficient to show that the bank was insolvent, but it is necessary to go further and establish by a preponderance of the evidence that at the time the deposit was made the bank was hopelessly insolvent.

The evidence in this case discloses that the bank had accumulated during a long period of years a considerable amount of worthless paper and perhaps a fair inference from the proof would be that in order to save the bank from bankruptcy it would require a considerable length of time and careful management, but this does not establish hopeless insolvency.

The bank had been examined from time to time by the state banking officers and its condition had remained practically unchanged for many years prior to the time it was closed; none of the examining officers had believed that the bank was in such a condition as to warrant closing the bank; none of them believed that the bank was insolvent; certainly none of the officials believed that the bank was hopelessly insolvent. The repeated examinations and the fact that the financial condition of the bank had remained practically the same for several years and during the time of these repeated examinations, and had not been closed by the officials, is strong proof that the bank

was not hopelessly insolvent. We would call the court's attention in this connection to the fact that the bank's reserve was always above what the law required

Judge Bean in passing upon this question in his memorandum decision says:

> "It is undoubtedly true, as was shown by the evidence, that the Kelso bank was in fact insolvent at the time it received the deposit in question, in the sense that it did not possess sufficient solvent and marketable assets to meet its obligations; but it was a going concern and continued to receive deposits, pay checks, and do a general banking business for three days thereafter, until forced to close by order of the banking department. Its condition at the time the deposit was made differed in no substantial way from what it had been for a long time prior thereto, and so far as I can ascertain from the evidence the officers of the bank did not know or believe at that time that the bank was hopelessly and irretrievably insolvent, but thought it would be able to continue in business."

Great weight should be given to this conclusion of the trial court based upon a question of fact. Having had the benefit of having the witnesses present in court testifying and the whole matter before him, the trial court concludes as a question of fact that this bank was not hopelessly insolvent. We think that the conclusion of the trial court upon this question is supported by the facts and circumstances in

this case and the evidence certainly falls far short of showing that at the time the deposits were made the bank was hopelessly insolvent.

In Morse on Banks and Banking, Section 629 (3rd Ed.) the author says:

> "The mere fact of insolvency does not make it dishonest to receive a deposit, but hopeless insolvency does."

That seems to be the general rule followed by the authorities. It is not enough that the bank was insolvent, but hopeless insolvency must be established.

In his memorandum opinion Judge Bean quotes on this point from a decision rendered by Judge Gray in *Quinn vs. Earle,* 95 Fed., 732.

> "A trader, whether a corporation or an individual, may be struggling in the straits of financial embarassment but with an honest hope of weathering the financial storm by being eventually solvent. Property received by such an individual or concern during the period of such embarrassment becomes honestly theirs, and the fact that their expectations were unrealized, and their hopes not well founded, would not fasten upon them a fraud that would vitiate their business transactions."

See also St. Louis & S. F. Ry. Co. vs. Johnston, 133 U. S., 576.

Quoting further from Judge Bean's memorandum

decision as being particularly applicable to this question:

> "Banks in many instances no doubt continue to do their regular and ordinary business for long periods though in a condition of actual insolvency, and it can surely be said that such a bank is to be regarded as a trustee *ex maleficio* for all the deposits received in due course of its business when there is no intention of closing its doors. There is often hope, if only the credit of the bank can be kept up by continuing its ordinary business and by avoiding any act of insolvency, that affairs may take a favorable turn and thus suspension be avoided."

The record in this case will disclose the amount of deposits received for several months prior to the closing of the bank, the amount of money paid out, and the fact that there was practically no change in the financial condition of the bank. It had not suffered any new losses immediately preceding the closing of the bank, no emergency matters had arisen, the bank was continuing as it had continued for a long time prior thereto.

The appellants in order to show that the bank was insolvent have quoted some of the testimony. The part quoted has a tendency to establish that the bank was insolvent at the time the officers took charge of it, but counsel have failed to draw the distinction between insolvency and hopeless insolvency.

Judge Bean in passing upon this question indi-

cated in his opinion that the bank was insolvent but not hopelessly insolvent within the meaning of the law. The courts draw a distinction between a bank that is insolvent and one that is hopelessly insolvent.

In order to create a trust *ex maleficio* of deposits the bank must have been hopelessly and irretrievably insolvent. That is the rule given in the cases cited by appellants in their brief.

Counsel quote from 3 R. C. L. 557, where the expression is used that the bank was *hopelessly insolvent*, and from *Bank vs. Webb,* 110 U. S. 7, where the expression is used, *hopelessly insolvent,* and in *Cragie vs. Hadley,* 99 N. Y., 131, the expression is *irretrievably insolvent.*

A careful reading of the decisions upon this question will disclose that the courts draw this distinction.

Hopelessly is defined by the Standard Dictionary as, "affording no ground of hope; desperate"; irretrievable is defined as "not retrievable; that cannot be retrieved or restored; remediless; irreparable."

While the evidence discloses that this bank had a considerable amount of outstanding paper that was of doubtful value, assuming that the bank had continued in the ordinary course of business and had not been taken charge of by the state officials it is fair to assume from the evidence that a considerable amount of the paper would have been collected and if there had been no unusual drain upon the resources

of the bank it would have eventually been able to meet its liabilities and continue in business. What the bank will pay when thrown into the hands of the liquidating officer is not a fair criterion of the financial ability of the bank to have continued in business if it had not been thrown into bankruptcy, for it is a matter of common knowledge that forced liquidation of a bank very materially destroys its assets and prevents a realization of many accounts which would have been collected if the bank had continued in business. Certainly this bank was not destitute of hope and was not in the condition that banks usually are that are denominated and termed hopelessly and irretrievably insolvent. It had the necessary reserve on hand in cash; there was no run upon the bank; it was continuing to transact business as it had been doing for months previously, and we do not believe that counsel can find any case where deposits were made under conditions such as existed here where the courts have held that the bank was so hopelessly insolvent as to make the deposits a trust fund.

II.

Have the appellants established by a preponderance of the evidence that the officers knew, or were legally chargeable with notice that the bank was hopelessly insolvent?

This question, like the one we have just discussed, necessitates keeping in mind the distinction between insolvency and hopeless insolvency.

From the evidence it is clear and beyond question that none of the officers connected with the bank actually knew of its embarrassed condition but the cashier; none of the other officers believed that the bank was insolvent or in any danger of insolvency. Stewart, the cashier, knew of the financial condition of the bank, but the evidence clearly indicates that he did not believe that the bank was insolvent, and certainly the evidence falls short of showing that he understood and believed that it was hopelessly insolvent. He knew that there was a large amount of paper outstanding, some of which was of doubtful value, but he firmly believed that if the bank was allowed to continue in business he would be able to collect practically all of the outstanding paper. The bank examiners who had examined the bank from time to time made no complaint of the insolvent condition of the bank to the directors. They did complain of some of the paper; there was no intimation that this paper endangered the solvency of the bank, and when the final action was taken to levy an assessment upon the stockholders it was not done with the idea that the bank was on the verge of bankruptcy, but was for the purpose of increasing the reserve and to give the bank a larger working cash capital and take the place of paper which the officials deemed worthless.

A careful reading of the transcript of record will disclose that the officers of the bank believed that the bank was financially able to continue in business.

Considering this bank in the light of the conditions which had prevailed for years prior to the time it was closed and up to the date of closing the bank, it is a fair conclusion to say that the officers of the bank had reasonable grounds for believing that the bank would be able to maintain its credit and surmount its difficulties.

On this point there can be but little doubt but that Stewart honestly believed that the bank could meet its liabilities and maintain its credit, and eventually be placed on a sound financial footing. The immediate cause for the officers taking possession of the bank was the failure of Stewart to meet the assessment levied against the stock held by him. There had been no run on the bank and no unusual drain upon its funds.

On this point we would call the court's attention to the case of *Brennan vs. Tillinghast,* 201 Fed., 609:

> "However, the mere fact that the bank is known to be insolvent at the time the deposit is received is not in our opinion sufficient of itself, without more, to confer this right of rescission upon the depositor, and such right of rescission would not arise when the bank at the time of receiving the deposit, although embarrassed and insolvent, yet had reason to believe that by continuing in business it might retrieve its fortunes; the necessary condition upon which the right of rescission is predicated being that the deposit was received when the bank was hopelessly embarrassed and so circumstanced as to constitute its

receipt of the deposit a fraud upon the depositor."

"A depositor cannot recover a deposit in preference to the general creditors on the ground that it was received while the bank was insolvent if the bank was ignorant of its condition. And even though knowing its insolvency there is no reason to require the officers to disclose the state of affairs to the depositor; they may have reasonable hopes of recovery and a deposit actually received and mingled with the bank's funds passes title and the depositor takes only as a general creditor." Morse on Banks and Banking, (3rd Ed.) Section 589.

"If the officers of the bank supposed the institution would be able to maintain its credit and surmount its difficulties they were under no legal duty to the plaintiff to disclose the state of its affairs. Silence with regard to a material fact which there is no legal duty to divulge will not vitiate the contract although it eventually operates to the injury of the party from whom the fact is concealed." 27 Fed. 543.

Quoting further from *Quinn vs. Earle,* supra:

"If the president and officers of the bank knew or believed that the bank was hopelessly and irretrievably insolvent at the time of receiving the deposit of the complainant, then a fraud was undoubtedly committed by the bank upon the complainant, for which there should be a remedy. But fraud must be proved, and is not to be presumed and the burden of proof is on the complainant. The mere fact that the bank

was in an embarrassed condition, by reason of the large indebtedness to it from its president, is not sufficient of itself to establish the fraud alleged in this case."

On this question Judge Bean held:

"The evidence in this case fails to show any intent or expectation on the part of the officers to close the bank at the time the deposit was received, but rather that it would be able to continue business in the usual manner. It is undoubtedly true that Stewart, the cashier, knew of its embarrassed condition and that it had a large amount of outstanding paper which it had carried for a long time, some of which was uncollectible, and a portion of which was of doubtful value, but the evidence does not show that he knew or believed that it was hopelessly insolvent at the time; on the contrary, the evidence indicates that he honestly believed, perhaps mistakenly, that the bank would be able to maintain its credit, surmount its difficulties, and continue in business."

The proof in this case amply supports this conclusion of Judge Bean and the record does not establish that the officers knew or believed that the bank was hopelessly insolvent; neither is there sufficient in the record to legally charge the officers with such knowledge.

Appellants have cited *State vs. Welty,* 118 Pac. 9, a Washington decision. A reading of that case will disclose that that was a criminal proceeding based

upon a penal statute and was not intended to apply to the question now before this court.

It might be that the statute would hold the officers of a bank criminally responsible for receiving deposits at a time when the bank was insolvent, but when it becomes a question between the creditors of a bank and whether certain depositors shall have a preference over other depositors, then the rule is that before a depositor can claim such a preference he must have made his deposit at a time when the bank was so hopelessly insolvent as to constitute a fraud upon him.

If the bank was hopelessly insolvent and the officers knew it or ought to have known of it by reason of their actual knowledge of the situation of the affairs of the bank, then the deposit might become a trust fund, but knowledge of ordinary insolvency would not make a deposit a trust fund, and that is all that can be charged here against the officers of the bank, that they had knowledge that the bank was insolvent, but there was no sufficient showing that any of the officers believed that the bank was hopelessly insolvent; they all believed to the contrary and they had substantial reason for believing to the contrary.

III.

It is contended by counsel that deposits made by the county treasurer in the bank became a special and not a general deposit.

In this connection we would call the court's attention to the fact that there was an agreement entered into between the treasurer and the bank that the bank would pay two (2%) per cent. upon the daily balances. The appellant in the bond given to the treasurer assented to that arrangement and interest was paid on the daily balances up to the time the bank closed.

The deposits were made by the treasurer as other general deposits were made from time to time and were checked against by the treasurer in the usual course of business. Interest was paid on the daily balances and there was no thought in the mind of the treasurer that he was making a special deposit. There was no understanding on the part of the bank that it was receiving special deposits. It knew that the funds in the hands of the treasurer were public funds and that the treasurer was personally responsible for the funds, but that it did not alter or change the situation in any particular. The treasurer had been accustomed to keeping a large amount of money in this bank, depositing it as other money was deposited and checking against it in the usual way; it was not deposited with any understanding that the same money would be returned to the treasurer, nor was it to be used for any specially designated purpose; it was not unlawful but was directly authorized and required by the laws of the State of Washington. The statutes requiring a bond to be given by the bank and the provisions requiring the bank to pay interest on daily balances

are sections 5562-5567 of Remington's Compiled Statutes of Washington, 1922.

This matter coming from the State of Washington and the bank having been incorporated under the laws of Washington and controlled by the laws of that state, the position of the supreme court of that state upon the character of the funds deposited by the officers of the state should be of controlling force upon this court on that question.

In *Kies vs. Wilkinson,* 101 Wash., 344, in passing upon this question the court held:

> "But as applied to insolvent banks in which deposits of public money have been made the better rule seems to be that, in the absence of statute, or a showing of facts sufficient to create a trust, a claim for public money has no preference over the claims of general creditors of the bank, but stands on the same footing with them. * * * While it is true that the funds deposited by respondent as county clerk of Clarke county implied a notice to the depositary that the funds were public funds and not private funds of the depositor, nevertheless the funds were deposited subject to check as an ordinary account, and, as such, constituted a general and not a special deposit."

In *Kies vs. Wilkinson, supra,* the supreme court of Washington cites with approval *City of Sturgess vs. Meade County Bank,* 161 N. W., 327. The court

will find in this case an extended discussion of this question and numerous citations of authorities.

In 5 Cyc. the rule is as follows:

> "(c) DEPOSITS OF TRUSTEES, PUBLIC OFFICERS, etc. The deposits made by trustees, executors, administrators, assignees, agents, public officers, and other persons who are serving as fiduciaries, are simply general deposits, and if the bank fails to pay them, beneficiaries have no peculiar claims or rights over other creditors. They must share like other depositors."

See also *McNulta vs. West Chicago Park Commissioners,* 99 Fed., 900. Among other things the court in this case said:

> "A deposit upon which interest must be paid cannot be special or in trust and in case of the failure of the bank must, for the purpose of payment, be on the same footing with other deposits or unsecured claims."

IV.

In the amended complaint the charge is made that with the funds deposited on the 14th of March, 1921, the Kelso State Bank purchased the warrants in question.

The evidence is clear and leaves the matter beyond question that the real transaction consisted in the Kelso State Bank borrowing from the United States

National Bank, first the sum of $7988.12 on the 20th day of September, 1920, and on the 6th day of December, 1920, the sum of $26,783.76, and deposited warrants as collateral security for the loan. The transaction was treated by all of the parties connected with it as a loan; interest was charged and paid upon the loans; at the expiration of the time fixed a renewal was given. The United States Bank treated it as a loan and reported it in its official reports as a loan and placed it in the loan account of the bank. The fact that the bank was given a paper which it denominated a re-purchase agreement does not alter or change the actual understanding and intention of the parties. The United States Bank held these warrants as a pledge and if the debt had not been paid could have foreclosed its pledge either by process of law, or, if the agreement was broad enough, the bank could have sold the warrants and applied the proceeds in liquidation of the debt and if there was not a sufficient sum realized from the sale it would have had a claim against the Kelso State Bank for the difference.

In passing upon this question the lower court said:

> The transactions were regarded as loans by both banks; they were renewed from time to time and interest charged and paid thereon. They were carried as loans on the books of the lending bank and were so reported by it. The so-called re-purchase agreement executed by the Kelso

> Bank at the time the warrants were delivered to the United States Bank were merely a convenient method of evidencing the transaction and did not change or alter the understanding and intention of the parties. When, therefore, the Kelso Bank paid the loan it simply re-possessed itself of that which belonged to it, but which had been pledged to secure the loan."

In *Blake vs. State Savings Bank,* 12 Wash., 619, the supreme court of Washington held that where money was deposited in an insolvent bank in the ordinary course of business and without knowledge on the part of the depositor of the insolvency of the bank, that the relation of debtor and creditor was created and that title to the money passed to the bank. It was claimed in that case that by reason of the fraud practiced by the officers of the bank in withholding from the depositor the insolvent condition of the bank that the contract of deposit between him and the bank was void and that title to the monies deposited never vested in the bank and it became a trustee *ex maleficio* of the fund; but the court held that the fact that the depositor became a creditor of the insolvent bank through the fraud of its officers and the bank a trustee *ex maleficio* gave the depositor no right to a preference over other creditors unless he could trace and recover his property.

So before appellants are entitled to the relief prayed for they must establish by a preponderance of the proof, not only that the bank was insolvent but

that it was hopelessly insolvent, and they must trace and recover the property itself or its proceeds.

This is not a transaction to establish a preferred claim against the assets of the bank, it is a proceeding to recover certain specific property based upon the theory that the bank was hopelessly insolvent at the time the deposit was made, and that by reason of the fraud the bank became a trustee *ex maleficio* and that the warrants in question were purchased from the deposits made by the treasurer under these conditions.

We have called the court's attention to the failure of the appellants to establish by a preponderance of the proof that the bank was hopelessly insolvent at the time the deposit was made, but, assuming for the purpose of meeting this contention of counsel that the bank was hopelessly insolvent when it received the deposit in question, and became a trustee *ex maleficio* of the fund, have the appellants shown that they are entitled to these particular warrants?

The warrants belonged to the Kelso State Bank. They had been the property of the Kelso State Bank for several months prior to the time this deposit was made. At the time the treasurer made the deposit on the 14th day of March, 1921, he was a general depositor of the bank having to his credit a considerable sum of money. On the 14th he deposited $35,000.00 and the amount deposited was passed to his credit and he was given a checking account for the full amount of the deposit and was thereafter

paid interest on the daily balances then on deposit. Some of these checks were taken by Stewart to the United States National Bank of Portland and placed to the credit of the Kelso State Bank. At that time the bank had a balance of some $14,000.00, making a total credit of nearly $50,000.00 in favor of the Kelso State Bank with the United States National Bank. Out of this balance the Portland bank took credit for the amount which the Kelso Bank was owing it and for which the warrants were held as security. No new property or securities were acquired in this transaction. It is impossible to tell what money was used in paying the debt of the Kelso State Bank. When the treasurer made his deposit so far as he was concerned the check was paid and he was given a cash credit for the amount of the check. The bank did not take the check for collection but accepted it and when taken to Portland it was used by Stewart as a matter of bookkeeping to have the bank at Portland take credit for the amount of the check, and so far as the treasurer was concerned the check was deemed collected when he made his deposit. The bank at Portland was paid the amount due it, amounting to about the sum of $32,000.00, out of the credit it had at that time of about $50,000.00 When the checks were delivered to the Kelso State Bank by the treasurer they became commingled with the funds of the Kelso State Bank. When taken to Portland and deposited with the United States National Bank by the Kelso Bank the amount represented by the checks be-

came commingled with the other funds then on deposit and to the credit of the Kelso Bank; and when the Portland Bank took credit for the amount due it it took credit against all of the funds then on deposit to the credit of the Kelso State Bank; the fund had become entirely commingled and there is no possible way of segregating or dividing that fund. This is a question of following the property; a question of property, and not a question of establishing an equitable right to a preference. The burden is upon the appellants to clearly establish the identity of the property and unless they have they must fail. They are not prosecuting this action based upon an equitable claim for a preference against the assets of the bank but are seeking to recover specific property upon the ground that they are the owners of it. They say the property was purchased with their money and unless they can establish that fact the court had no power to pass upon any other matter, for it is not within its jurisdiction nor within the pleadings. It is a question of identity of property, of ownership.

Upon this question we would call the court's attention to *Spokane County vs. Clark,* 61 Fed., 538. This case was affirmed by the circuit court of appeals in 68 Fed., 979. We desire to call the court's attention to this language from the decision of the District Judge in the case just cited:

> "The statute is founded upon principles of justice and equity, and I find in the facts of this case no basis in reason for a decree requiring the

> receiver to take from the other creditors their just and ratable portions of what may be left to them of the assets of this bank, in order to save Spokane County or its treasurer from loss."

We would also call the court's attention to *Multnomah County vs. Oregon National Bank,* 61 Fed., 912, a case where the court was passing upon the question of preference for county funds deposited in a bank that became insolvent. The court among other things said:

> "His so-called right of preference, in other words, cannot in justice extend to the property of others. The theory of preference does not apply in these cases. There is no preference by reason of an unlawful conversion. The so-called right to be preferred in the case of a wrongful conversion is a right of ownership, a right of property; a right which lays hold of the property whether in its original or in a substituted form; a right which follows the property so far as it can be ascertained to be the same property or its product, and only does so because the property to be reached can be ascertained to be the same property or its product. When the means of ascertainment of the identity of property or proceeds fails the right fails."

The clearly established fact that the warrants in question were owned by the bank long prior to the time the deposit was made establishes conclusively that the proceeds of this deposit were not used for the purpose of purchasing these warrants. The most

that can be said is that some of the money was used for the purpose of paying the debt of the bank for which these warrants were held as collateral security, but that would not give appellants title to the warrants, and that is the form of action which they commenced here and it is only upon that theory that they are entitled to recover.

In addition to that we would call the court's attention to the rule that money deposited in an insolvent bank and used by it in paying its debts does not create a preference. Quoting from 195 Fed., 606:

> "Moreover the deposit of checks of third persons which are credited to the depositor and used by the bank to pay its debts bring no money into its fund of cash and form no foundation for preferential payment to the depositor." Citing *City Bank vs. Blackmore,* 75 Fed. 771; 21 C. C. A., 514.

And, quoting further from this decision:

> "Again, checks of third parties deposited with a bank credited to the depositor and collected through a clearing house lay no foundation for a preferential payment, the absence of proof of the actual balance of cash the bank received on account of them, for they may have been and usually are used in whole or in part to discharge the debts of the bank."

In re: *Receivership of Bank of Minnesota,* 74 N. W., 136, the court held that where a number of

checks of various amounts were deposited by the city with the bank and the checks passed through the clearing house and were used in paying the debts of the bank, that although the funds were trust funds that the city was not entitled to a lien or trust in its favor on the assets in the hands of the receiver and was not a preferred creditor.

In *Rugger vs. Hammond,* 95 Wash., 85, the supreme court of Washington cited with approval the case of *Jones vs. Chesebrough,* 75 N. W., 97. The court in that case said:

> "All that can be said is that a failing bank received the money and paid it out in the usual course of business to its creditors, under circumstances that show that the assets of the bank were no more at the date of the assignment than they would have been had the deposits not been made. The bank had not only used the money coming in as deposits, but had borrowed money to pay on its debts, showing a purpose to apply all money in that way, be the same more or less. While the payment of debts in that manner by a trust fund lessens the indebtedness of an insolvent estate, and may thereby increase the percentage of dividend to be declared from other funds, it does not follow that the assignee has any increase of assets because of it. It may follow that he has less debts to pay, and the estate is in that way benefitted. But such a benefit to creditors is but partial, and, if such a payment is to serve as a reason for withdrawing an equal amount from the assignee, the result is

> an absolute loss to the creditors. We do not think a preference should be sustained under such conditions."

If the debts owing to the United States National Bank had passed into the hands of the liquidating officer that officer would have been authorized to pay the debt and to have received from the bank the warrants in question. That alone establishes the character of the transaction as a loan.

Assuming that the Kelso bank was indebted to the Portland bank and that the Portland bank had collateral of much greater value than the debt, clearly the liquidating officer could have paid the debt and been entitled to the security; and if in paying the debt trust funds were used the *cestui que* trust would not become the owner of the collateral security, the collateral had belonged to the bank before the deposit was made and the deposited money was simply used for paying the debt of the bank.

We will assume, as a matter of argument, that the money was wrongfully accepted by the bank at a time when the bank was hopelessly insolvent but used by it in payment of its debt. There was no new assets added, no new property brought in, the bank's debt had been paid. The theory of following property is based upon the right of property and the courts proceed upon the principle that the title has not been affected by the change made of the trust fund; but here nothing was acquired by the use of

the trust fund, it was used for the purpose of paying the debt of the bank.

V.

The evidence upon this matter leads to the inevitable conclusion that after the debt for which the warrants were held as collateral had been paid that the warrants were left at the Portland bank with the hope on the part of Stewart that arrangements could be made with the county treasurer for securing additional deposits based upon the warrants left with the bank. The transaction was not completed, the warrants were not accepted by the county treasurer and no further action was taken relative to the warrants.

The lower court in disposing of this point said:

> "The evidence is clear that the purpose of the Kelso bank in leaving the warrants with the United States Bank was not to secure deposits of county funds already made, but in the hope that it would be able to obtain future deposits of such funds."

In the amended complaint the appellants claimed ownership of these warrants based upon the allegations that the warrants were left with the bank for the use and benefit of the treasurer of Cowlitz County *theretofore* deposited by said treasurer in said Kelso State Bank, and they now seek to secure title to the warrants upon the theory that the transaction

created a trust in the nature of a pledge to secure the deposits for which these companies were liable.

If counsel now rely upon the allegations of the amended complaint that this arrangement was made to secure deposits theretofore made, then they are face to face with the fact that no such understanding was had; but the understanding, so far as there was any, was to the effect that the warrants were to be left for the treasurer in order that the bank might secure additional deposits. If they now rely upon the fact that they were left for the purpose of securing additional deposits they are against the fact that no additional deposits were secured on that account.

When the Portland bank was paid in full it had no further claim on these warrants. There was no obligation of any character existing between it and the Kelso bank so far as these warrants are concerned; there was no present obligation of any character between the Kelso bank and the treasurer so far as these warrants were concerned; the treasurer was under no obligations to either of the parties, no benefit could come to him and no consideration of any character moved to him by reason of the fact that the warrants were left with the Portland bank. He had security for all of the deposits he was making with the Kelso bank; he did not ask for these warrants and so far as the record stands would not have received them if they had been offered to him; he never did receive them, and it is probable that many of them,

under the law, he could not have received. The Portland bank was merely the agent of the Kelso bank in holding the warrants for the bank and the arrangement between the Portland bank and the Kelso bank had no more force than if the Kelso bank was contracting with itself. If Stewart instead of leaving the warrants with the Portland bank had taken them to Kelso and placed them in the vaults of the bank and had placed on them a memorandum stating that these warrants were to be held for the county treasurer to secure additional deposits the liability would have been the same as where the warrants were left temporarily in the custody of the Portland bank, and the fact that the Portland bank gave a receipt to the Kelso bank stating that it would hold the warrants for the treasurer as directed by Stewart did not in any manner change the legal status of these warrants.

If the treasurer had not had any security for the money deposited by him with the Kelso State Bank it could not be contended that he could have maintained an action to recover these warrants to liquidate the claim against the bank for the money deposited in the bank for he had never accepted the warrants; unless he had, the fact that they had been left with a third party for acceptance by him could not possibly give him any right over other creditors of the bank and the appellants are in no better position than the treasurer.

But the facts here are not nearly so strong as in the supposed case just cited, for here the treasurer had no money on deposit for which these warrants were left with the bank to secure him. The treasurer had no claim on these warrants; no action had been taken by him which resulted in a binding contract upon the parties. Stewart could have revoked the agency of the bank in holding the warrants any time before action had been taken by the treasurer.

There seems to be a rule in equity that where one delivers to or leaves in the hands of another a fund with which to satisfy an obligation of the former a duty in the nature of a trust is thereby created.

This principle is governed by the following rule:

> "To give a third party, who may derive a benefit from the performance of the promise, an action, there must be, first, an intent by the promisee to secure some benefit to the third party, and second, some privity between the two, the promisee and the party to be benefited, and some obligation or duty owing from the former to the latter which would give him a legal or equitable claim to the benefit of the promise, or an equivalent from him personally. It is true there need be no privity between the promisor and the party claiming the benefit of the undertaking, neither is it necessary that the latter should be privy to the consideration of the promise, but it does not follow that a mere volunteer can avail himself of it. A legal obligation or duty of the promisee to him will so connect him

with the transaction as to be a substitute for any privity with the promisor, or the consideration of the promise, the obligation of the promise furnishing an evidence of the intent of the latter to benefit him and creating a privity by substitution with the promisor. A mere stranger cannot intervene and claim by action the benefit of the contract between other parties. There must be either a new consideration or some prior right or claim against one of the contracting parties, by which he has a legal interest in the performance of the agreement."

In this case there was no legal obligation resting upon any of the parties. There was no consideration moving between any of the parties. Stewart was planning to have the treasurer accept these warrants so that he might get additional deposits; it was an uncompleted arrangement, never consented to or acquiesced in by the treasurer; the bank was in no sense a party to any of this transaction other than a mere custodian of the warrants. The rule stated above is taken from *Vrooman vs. Turner,* 25 Am. Rep. 195.

In 9 Cyc., 380, the author says:

"By the weight of authority the action cannot be maintained merely because a third person will be incidentally benefited by performance of the contract; but he must be a party to the consideration, or the contract must have been entered into for his benefit, and he must have some legal or equitable interest in its performance."

The treasurer would not in any manner have been benefited by the performonce of the contract. He was not required to make any further deposit with the bank and before he did he could have demanded satisfactory security, and until some action was taken no consideration could pass to him. He was not a party to the consideration. The contract between the Portland bank and the Kelso bank was not entered into for his benefit; the fact is there was no contract, the bank became merely the agent and custodian for the Kelso bank; the treasurer had no legal or equitable interest in its performance until he had in some manner agreed to the arrangement which comprehended some future dealing and action between the parties, and under such circumstances consent on his part would have been essential before it would become a binding contract upon any of the parties.

Appellants contend that even though the transaction betwen the Kelso bank and the Portland bank constituted a loan, yet they are entitled to the securities because it is claimed that their money was used to pay the debts for which these warrants were held as collateral.

There are several reasons why this contention cannot be sustained. In the first place they have failed to establish that the bank was hopelessly insolvent at the time the deposit was made; they have failed to establish that the officers of the bank knew or are chargeable with knowledge that the bank was hope-

lessly insolvent; they have failed to trace the money that was deposited by the treasurer in the Kelso State Bank on the 14th of March, 1921; they have failed to prove that their money was used in the purchase of these warrants, at the most the evidence merely showing that some of their money was used for paying the debts of the bank.

The evidence discloses that if any of the money deposited by the treasurer was used in this connection it was for the purpose of paying the debt of the Kelso bank. Appellants did not commence this action to establish a lien for these warrants, but commenced an action alleging that they were the owners of the warrants and based their right of recovery upon the fact that their money had purchased the warrants. The payment of the debt of the bank with money deposited by them would not give them a right to these securities as against other creditors of the bank.

There is another reason why appellants cannot prevail in this matter and which we think is absolutely conclusive, and that is a law which prevails in the State of Washington that the property of an insolvent corporation is a trust fund for creditors and a voluntary preference is void. This matter was first before the court in *Thompson vs. Huron,* 4 Wash., 600, and is followed by *Conover vs. Hull,* 10 Wash., 673, and a long line of decisions until it has become a firmly settled rule in this state.

In *Allen vs. Baxter,* 42 Wash., 434, it was con-

tended by the appellants that the complaint was insufficient because it contained no allegation that the appellants knew that the corporation was insolvent at the time the attachment was sued out, and in passing on that point the court said:

> "We think this is not necessary. If, as a matter of fact, the corporation was insolvent at the time of the levy of the writ the funds of the corporation were trust funds for the benefit of the creditors thereof."

The rule is now firmly established in Washington that an insolvent corporation in fact cannot turn over any of its property to one of its creditors which would give it a preference over the other creditors. In this case in order to give the appellants any standing at all it is necessary for them to show that at the time the transaction occurred between the Kelso State Bank and the United States National Bank in which the warrants in question were left with the bank the Kelso bank was then hopelessly insolvent. That being true, it was not then in a position to prefer one creditor to another and any assets turned over to one creditor as security for an existing debt would have been absolutely void under the decisions of the State of Washington. In the amended complaint it is alleged that these securities were left with the United States National Bank to secure the county treasurer for deposits theretofore made with the Kelso State Bank. Under the Washington decisions the relation of debtor and creditor existed between the

Kelso State Bank and the treasurer, and the Kelso State Bank was indebted to the treasurer for the amount of the deposits. If it undertook to give additional security for the debt then owing from the bank to the treasurer it would be merely giving assets to one creditor to secure him for an existing liability and would have the result of giving him a preference over the other creditors. And, indeed, that is exactly what the appellants are contending for in this case. They conted that at that time the Kelso State Bank was hopelessly insolvent and that the cashier left these warrants with the United States National Bank to be held for the treasurer as additional security for what the bank then owed the treasurer and they are now claiming by reason thereof that they are entitled to a preference over the general creditors of the insolvent bank. If additional deposits had been secured under this arrangement a different question might arise, but since nothing of that kind occurred and the only excuse for claiming these warrants is that they were intended as additional security for the deposits previously made by the treasurer, the rule given is conclusive against the right of recovery. The bank and the treasurer, the only directly interested parties, being residents of the State of Washington, the laws of Washington should be taken as controlling the interpretation of the liabilities of the respective parties under the arrangement.

VI.

In our answer herein we pleaded as a defense that the appellants had each presented its claim for the amount of money it paid to the treasurer on account of the bonds given by the bank to the treasurer, and the record now stands that these claims were presented by these companies to the liquidating officer and approved as general claims.

The liquidating officer took charge of the bank on the 17th day of March, A. D. 1921, and these claims were presented and approved on the 25th day of April, A. D. 1921. It is also in the record that several months following the proof of these claims dividends were paid on the claims and accepted by the plaintiffs.

Counsel in their trial brief contended that these facts do not establish an estoppel. We are not basing our defense in this matter upon the ground of estoppel but upon an election of remedies. According to appellants contention they had two remedies. They could either present their claims and continue the relation of debtor and creditor, or, they could elect to present a preferred claim; or if their money or its product could be identified then they might elect to take the property. These remedies are inconsistent and they could not pursue all of them at the same time and when they have elected to pursue one they are barred from pursuing the others unless there is some circumstance which would relieve them.

In *Longfellow vs. Seattle,* 76 Wash., 509, the court used this language:

> "For authority on the proposition that the adoption of one remedy by a person having a choice of remedies bars the right to invoke another, we need not look beyond our own cases."

Citing a number of authoritities.

In *Vol.* 20, *page* 32, C. J., the rule is given:

> "As a general rule the presentation of a claim against the estate of an insolvent or of a decedent constitute such an election of remedies as will preclude the subsequent prosecution of an action or suit based on an inconsistent remedial right."

Counsel have cited as controlling in this matter the case of *Standard Oil Co. vs. Hawkins,* 74 Fed., 395, and in *re*: *Stewart,* 178 Fed., 463. In the *Standard Oil Co. vs. Hawkins* a claim was presented and approved by the receiver in charge of an insolvent bank. The dividends were ordered paid but the claimant in this case refused to accept the dividends, and withdrew the claim.

It was stated in an action brought by the claimant that at the time the claim was allowed it had no knowledge that it had the right under the law to demand the proceeds of drafts, etc., but supposed and understood that its only right under the law was to prove its entire claim and share with others in the distribution of the funds, that the proof of the claim was prepared by the receiver upon forms furnished by

the comptroller and were executed at the request of the receiver. The deposit in this case was made just a few minutes before the bank closed. The court in that case held that the claimant had the right to withdraw its claim and to pursue the property. In the other case relied upon by counsel the plaintiff was seeking to force the trustee in bankruptcy to return to him a claim which he had presented and which the plaintiff claimed had been presented at a time when he was ignorant of the facts and of his rights, and the court held in that case that he was entitled to the withdrawal of his claim. In neither case had dividends been accepted and the facts in both cases are unlike the facts in the case now before this court.

The appellants in this case are engaged in the bonding business, furnishing securities for public officers, banks, and various other persons and institutions; there can be no question of their familiarity with matter of this kind and of their rights in bankruptcy and receivership proceedings. It is no doubt true that these companies have regular attorneys retained by the year who are capable of keeping them informed of all of their legal rights. Here it appears that the Fidelity & Deposit Company, at least, had its resident agent working in this bank; he was familiar with all of the affairs of the bank, was familiar with the warrants held by the United States National Bank, and was familiar with the deposits made from time to time by the county treasurer. The fact stands out clearly that he was as familiar with

the conditions of the bank and the business transactions as was the cashier. He was the assistant cashier working directly with Stewart. The evidence disclosed that upon the failure of the bank one of the principal general managers of these companies came to Kelso to make an investigation; he had full opportunity of investigating all of the facts connected with the bank and its dealings with the county treasurer; under their bond they were given full opportunity of investigating conditions of the bank; before they paid the treasurer they had full opportunity of making inquiry into all of the dealings between the treasurer and the bank; notwithstanding all of these facts, after having paid the treasurer the amount then owing from the bank to the treasurer they presented their general claims about a month and a third after the failure of the bank. How can they now say that they did not know that the treasurer was making these deposits, or when he was making them, when the whole matter was before them and with full opportunity of finding out every fact connected with it? And there can be no question or doubt but what they did make investigation. In this case these appellants base their claims upon an assignment from the county treasurer, their rights are in no manner superior to the rights which the treasurer had if he had no bonds and had presented his claim. The treasurer was fully informed as to when the deposits were made so we think that these plaintiffs are not in a position to plead ignorance of the facts and thereby avoid the effect of the

presentation of their general claims to the liquidating officer. In addition to that, months after the general claims were allowed and with full knowledge of the general condition of the bank and the time when the deposits were made by the treasurer, dividends were paid and were accepted by these plaintiffs. The Fidelity & Deposit Company in accepting its dividend attempted to make a reservation relieving it from its conduct. At that time this action had been commenced and it was fully informed as to all of the circumstances connected with the warrant deal.

The filing of a claim and the acceptance of dividends upon a claim are absolutely inconsistent with the claim of ownership of the warrants arising through the deposits made by the treasurer on the 14th of March, 1921. These two positions being inconsistent, this plaintiff cannot accept dividends on its general claim and at the same time endeavor to recover the property. The only basis which would excuse it from the effect of the presentation of its claim would be ignorance of the facts. How can it plead that defense here?

In *Clausen vs. Head,* 85 N. W., 1028, in passing on the question of election of remedies, the supreme court of Wisconsin used this language:

> "Having made an election between two courses, with knowledge of the facts, he waived the one not chosen." (Citing authorities.)

Quoting further from that decision:

> "The doctrine that intent to make a choice between inconsistent remedies is essential to a choice, and that absence of such intent will relieve one from the effect of the rule we have discussed, applies only where action in the first instance was taken in ignorance of the facts. (Citing authorities.) Where knowledge of the facts exists consent is conclusively presumed as a matter of law, and such presumption cannot be affected by any declaration or reservation of a right to take a different and inconsistent course at a subsequent time."

Having elected to accept the dividend with full knowledge of all of the facts, the plaintiffs irrevocably have bound themselves to the choice of continuing the relation of debtor and creditor.

We have been unable to find any case where dividends have been accepted on claims presented which allowed the parties thereafter to elect to pursue a different course. In both cases relied upon by counsel no dividends had been accepted and in both of those cases the claimants had withdrawn or were trying to withdraw the claims presented. In this case neither of the appellants has made any attempt to withdraw the claim; they are still relying upon their claims and have accepted the dividends upon them, and how can they claim the right to still continue to pursue two different and inconsistent remedies? Certainly before they can maintain this suit

they must abandon their claims and withdraw them, but not only have they refused to do that, but the claims are still valid and existing claims.

We contend that appellants cannot occupy these inconsistent positions and having elected to present their general claims and having accepted dividends upon them they cannot attempt to follow the property as they are trying to do in this case, and the receipt given by the Fidelity & Deposit Company at the time it accepted the dividend did not in any manner alter its legal status, for it could not change its legal election by making a reservation of that character; besides, the reservation did not cover the warrants in question.

The case of *Potts vs. Schmucker,* reported in 35 L. R. A. 392, we think is conclusive of this question and is the only decision we have been able to find which covers the facts as they have been disclosed in this case. Quoting from that decision, the court says:

> "While it is true that a bank which, being insolvent and knowing it, takes funds on deposit thereby commits a gross fraud on the depositors, yet it becomes the duty of the depositor to elect whether he will repudiate the transaction and reclaim the money deposited, or affirming permit the relation of debtor and creditor between him and the bank to stand undisturbed.
>
> "The relation between a bank and its creditors is that of debtor and creditor, and if a fraud has been perpetrated by the bank in accepting the

deposit, the depositor may rescind the contractual relation and recover back the money; but if he affirms the contract, he surrenders his right of rescission. Now all of these depositors have proved their claims in the insolvent proceedings and taken their dividends. They have consequently elected to adhere to the contract and it is too late to rescind it now."

VII.

There is one other subject that we desire to call to the court's attention and that is the contention of the appellants that they are entitled to a preference over the other creditors because at the time the deposits were made the bank was hopelessly insolvent. It appears from the record that the bank had been in practically the same condition for a long time preceding the 17th of March, 1921; during the several months preceding the 17th of March, 1921, a large amount of deposits were made, running into several hundred thousand dollars; these depositors would have the same right of preference that these appellants claim; if appellants are entitled to preference then practically all of the other creditors are entitled to preference and they have the same right to claim it that these appellants have, for these appellants so far have not made claim to a preference to the liquidating officer. This being a court of equity these matters should be taken into consideration and if one creditor is entitled to a preference then all of the

other creditors who are in the same position are entitled to share with these creditors.

In closing we would call the court's attention to the fact that these appellants were compensated sureties, that their dealings with the bank grew out of a contract for which they were being compensated. The rule now seems to be that a compensated surety is not entitled to any more favors than ordinary persons or corporations.

Here were these appellants, getting a consideration for their undertaking, to now permit them to be paid in full while the other creditors who occupy similar positions can only be paid in part would be inequitable and unfair under the facts disclosed in this case, and we feel that before a preference should be allowed of the character claimed in this case in a court of equity that the conditions warranting it should be absolutely clear and beyond any question of legal dispute. There is no reason in equity why Cowlitz County or the treasurer of Cowlitz County, or the bonding companies should be paid in full and the other general creditors suffer heavy losses, for they were all general depositors and the deposits were made under like conditions and were general checking accounts.

We therefore submit that the appellants should be denied any claim to the warrants in question and

that the judgment of the District Court should be affirmed.

Respectfully submitted,

MILLER, WILKINSON & MILLER,
Solicitors for Appellee.

A. L. MILLER,
Of Counsel.